

Decision 02-12-069 December 19, 2002

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking to Establish  
Policies and Cost Recovery Mechanisms for  
Generation Procurement and Renewable  
Resource Development.

Rulemaking 01-10-024  
(Filed October 25, 2001))

**OPINION ORDERING PACIFIC GAS AND ELECTRIC  
COMPANY, SAN DIEGO GAS & ELECTRIC COMPANY, AND  
SOUTHERN CALIFORNIA EDISON COMPANY TO ENTER INTO  
AND COMPLY WITH THE ATTACHED OPERATING ORDER**

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SAN DIEGO GAS & ELECTRIC COMPANY, AND  
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**I. Summary**

This decision adopts the Operating Order under which Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), and Southern California Edison (SCE) will perform the operational, dispatch, and administrative functions for the California Department of Water Resources (DWR) Long-Term Power Purchase Contracts as of January 1, 2003. The Operating Order sets forth the terms and conditions under which the utilities will administer the DWR Contracts and requires the utilities to dispatch all the generating assets within their portfolios on a least-cost basis for the benefit of their ratepayers.

This decision is consistent with Assembly Bill 1 of the First Extraordinary Session (AB X1, Stats. 2001, Ch.4), which authorized the DWR to purchase electricity and sell it to the retail customers of the utilities (with the utilities acting, in effect, as DWR's billing agent) and Section 80260 of the Water Code, under which DWR's authority to make such purchases expires on December 31, 2002.

This decision approves the Operating Order attached to this decision and orders the utilities to comply with the order. The Operating Order is a modified version of the draft Operating Agreement attached to DWR's Memorandum dated November 6, 2002. The reasons for the modifications are discussed below.

## **II. Procedural Background**

On September 19, 2002, the Commission issued Decision (D.) 02-09-053, which ordered PG&E, SDG&E, and SCE, collectively referred to as the “utilities,” to assume all of the operational, dispatch, and administrative functions for the DWR Contracts. The decision also allocated the DWR Contracts to the resource portfolios of the three utilities to be scheduled and dispatched in a least-cost manner.

D.02-09-053 also directed the utilities and DWR to jointly file proposed Operating Agreements and Proposed Standards for Reasonableness Review by October 1, 2002, and, if there remained specific issues where agreement could not be reached, highlight those differences in a companion comparison exhibit.

On September 25, 2002, PG&E requested an extension of time to file the documents pursuant to Rule 48(b) of the Commission’s Rules of Practice and Procedure. By letter dated September 26, 2002, SCE and SDG&E joined PG&E’s request. The Commission’s Executive Director, in a letter dated September 27, 2002, granted a one-week extension, until October 8, 2002, for filing the documents.

On October 8, 2002, DWR transmitted to the service list a memorandum from Peter Garris of DWR in response to D.02-09-053 along with a proposed initial draft of an Operating Agreement. PG&E, SDG&E, and SCE filed timely comments on the initial draft operating agreement and Proposed Reasonableness Standards for Utility Administration of Allocated DWR Contracts. SDG&E’s comments included a draft operating agreement in the form of a red-lined version of DWR’s initial draft.

On October 18, 2002, PG&E, SCE, SDG&E, DWR, and Sempra Energy (Sempra) filed comments and proposed revisions to the draft initial Operating

Agreements and Reasonableness Review Standards. Aglet Consumer Alliance (Aglet) also filed comments on the proposed reasonableness standards. PG&E, SDG&E, SCE, and DWR filed replies on October 23, 2002.

On November 6, 2002, SDG&E filed a Motion for Leave to file Updated Information regarding the Operating Agreement. SDG&E indicated that it had reached consensus with DWR on additional issues and that it was in the best interest of the Commission to grant its motion. DWR also submitted a revised draft Operating Agreement on November 6, 2002 via a Memorandum transmitted to the service list in the proceeding.

By ruling dated November 6, 2002, the assigned administrative law judge (ALJ) granted SDG&E's motion and invited other interested parties to file updated information if desired. The ruling also provided an opportunity for parties to comment on SDG&E's and DWR's updated information and well as any other updates filed, by November 8, 2002. SDG&E and SCE filed replies on November 8, 2002.

It is clear that the utilities and DWR have been working diligently to reach consensus on an Operating Agreement, unfortunately they have not succeeded. On December 9, 2002, DWR submitted a Memorandum to the Commission commenting on both the Draft Decision and Commissioner Peevey's Alternate. DWR requests that the Commission order the utilities to enter into a revised "operating agreement" pursuant to Water Code Section 80106(b). DWR states that the revised operating agreement incorporates many of the changes to DWR's Draft that are contained in the Draft Decision, but reflects additional changes DWR believes are necessary to meet its statutory and contractual obligations. DWR states that, up to this point in time, it has not requested Commission action

in connection with its Water Code §§ 80106(b) <sup>1</sup> request and that currently, it is requesting the cooperation of the Commission under Section 80016.<sup>2</sup>

DWR's current request is inconsistent with its prior submittals in this proceeding, which requested that the Commission adopt operating agreements. DWR's July 20, 2002 Memorandum submitted as part of the DWR Contract Allocation phase of this proceeding, states:

“Consistent with the timeframe established in Rulemaking 01-10-024, the California Energy Resources Scheduling Division of the California Department of Water Resources (“CDWR”) submits this memorandum to the California Public Utilities Commission (the “CPUC” or “Commission”) to address the basis for requiring an operating agreement between DWR and each of the investor-owned utilities (IOUs) in connection with the allocation of CDWR's long-term contracts...”

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<sup>1</sup> Section 80106(b) states, in pertinent part, “at the request of the Department, the Commission shall order the related electrical service corporation... to provide billing collection and other related services, as agent of the Department.”

<sup>2</sup> Section 80016 states in pertinent part that “all states agencies and other official state organizations...are hereby authorized to, at the request of the Department, give the Department reasonable assistance or other cooperation in carrying out the purposes of this division.”

In the same memorandum DWR also states:

“CDWR believes that the Commission will need to adopt general principles related to certain operational and financial issues so that such principles can become the basis for an operating agreement that defines the rights and responsibilities of the parties as to contract administration and management. The principles could be established in the Commission’s procurement proceeding, and the actual operating agreement could be addressed in a subsequent proceeding.”

Subsequently, following release of the Draft Decision of ALJ Gottstein regarding DWR Contract Allocation, DWR submitted a Memorandum dated September 6, 2002. In Section 3 of that memorandum, under the heading “DWR Requests Separate Operating Agreements” DWR states: “To implement the operational arrangements imbedded in the final Decision, DWR believes that two distinct documents will be involved. First, for the reasons delineated in previous sections, DWR believes that operating protocols will need to be developed to encompass the operational arrangements required under the final Decision.”

We recognize that DWR believes that an operating agreement is the most effective means by which DWR can manage and discharge its responsibilities, we cannot order the utilities to enter into the revised operating agreement at this time. We cannot, as a practical matter, adopt an “operating agreement” when there is no agreement between the parties. It is for this reason that we are adopting an “operating order” today.

We understand that DWR believes there is a realistic possibility that such an Operating Agreement can be worked out with the utilities through continued negotiations and we continue to support these efforts. The utilities may continue to negotiate with DWR to attempt to reach consensus on a mutually acceptable Operating Agreement. If such an agreement is reached, the utilities should

submit the agreement to the Commission for approval and request termination of the Operating Order. Assuming that the agreement is substantially similar to the Operating Order we adopt today, we anticipate that it could be approved on an expedited basis, after the necessary public review and comment.

### **III. Need for the Operating Order**

In January 2001, in response to the energy crisis facing California, the Legislature gave the DWR authority to purchase electricity and sell it to, among others, retail customers of the utilities.<sup>3</sup> Utilities' were to provide transmission and distribution for DWR-purchased electricity. The utilities were also to provide billing, collection and related services for both.

Under ABX1-1, DWR's authority to contract for such purchases is not perpetual. Water Code Section 80260 provides that DWR's authority expires on January 1, 2003.<sup>4</sup> Water Code Sections 80000 and 80003 further demonstrate that DWR's authority was an emergency measure designed to stabilize a crisis. Both the Commission and the Legislature have clearly expressed their intent to eliminate the need for DWR to continue procuring power for the utilities after January 1, 2003, consistent with the utilities' statutory obligation to serve their customers.

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<sup>3</sup> Water Code Section 80002.5

<sup>4</sup> Water Code Section 80260 provides in pertinent part that "[o]n and after January 1, 2003, the department shall not contract under this division for the purchase of electrical power."

Consistent with the intent of ABX 1, one of this Commission's fundamental short-term goals is to transition full responsibility for energy market related activities back to the utilities as soon as possible. We should therefore make every effort to relieve DWR from the responsibility to perform any functions that should be performed in the long term by regular market participants. We note that this direction is consistent with the fact that the utility, and not DWR, continues to have a statutory responsibility to serve its customers. The utilities' obligation to serve their customers is mandated by state law and is part and parcel of the entire regulatory scheme under which the utilities received a franchise and under which the Commission regulates utilities under the Public Utilities Act. (See, e.g. Pub. Util. Code §§ 451, 761, 762, 768, and 770.)<sup>5</sup>

In its September 6, 2002 Memorandum in response to the Draft Decision of ALJ Gottstein regarding the allocation of power contracted by DWR under long-term contracts, DWR requested that the Commission direct the utilities to propose appropriate operating protocols in a separate operating agreement, for approval by the Commission.

DWR noted that, as proposed, ALJ Gottstein's Draft Decision provides that DWR would retain legal and financial responsibilities associated with the Contracts, while the utilities would act as DWR's agent in matters related to the day-to-day operation, including dispatch and scheduling of the Contracts. DWR stated that an operating agreement was necessary to fulfill its contractual obligations and provide assurance to the relevant parties that DWR maintains

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<sup>5</sup> As we explained in D.01-01-046, "a bankruptcy filing or the threat of insolvency has no bearing on this aspect of state law. Even utilities that file for reorganization must serve their customers. The public safety, and the economy's health will be impaired if the utilities avoid their obligation to serve."

the ability to monitor performance, obtain timely information, and adjust its revenue requirement. D.02-09-053 subsequently directed the utilities to file proposed Operating Agreements for our review and approval.

With DWR no longer in the business of procuring electric power on behalf of the utilities' customers as of January 1, 2003, the utilities will now perform all the day-to-day scheduling, dispatch, and administrative functions for the DWR contracts allocated to their portfolios, just as they will perform those functions for their existing resources and any new procurements. We can now eliminate the duplicative DWR scheduling apparatus that was put in place on a temporary basis under emergency conditions. It is not in the state's interest to allow two entities to continue to perform overlapping functions. Moreover, we should not continue to allow the utilities to utilize the states' resources, interest-free, to fulfill their obligation to serve.

The utilities will resume procurement by January 1, 2003. As we stated in D.02-09-053, we believe that the best way to coordinate DWR and utility resources as the utilities resume procurement is to put all of these resources under the control of the utilities, to be scheduled and dispatched in a least-cost manner, subject to our oversight.

#### **IV. Legal Authority for Operating Order**

Today's decision ordering the utilities to comply with the Operating Order derives from the explicit statutory authority provided in Water Code Sections 80016 and 80106 (b) and from the Commission's general statutory authority under Pub. Util. Code § 701.

Water Code Section 80016 provides in pertinent part that all state agencies "shall and are hereby authorized to, at the request of the department [i.e.,DWR], give the department reasonable assistance or other cooperation in carrying out

the purposes of this division.” Water Code Section 80106 (b) provides that, at DWR’s request, “the commission shall order the related electrical corporation... to transmit or provide for the transmission of, distribute the power and provide billing, collection, and other related services, as agent of the department, on terms and conditions that reasonably compensate the electrical corporation for its services.”

The utilities continue to challenge the Commission’s authority to order compliance with the Operating Agreement as does Sempra. The arguments advanced by the utilities and Sempra are generally the same as those addressed in D.02-09-053 and are now the subject of applications for rehearing. The Commission will address those arguments in its disposition of the rehearing applications. We will not revisit today ground that we have already covered in D.02-09-053. We are here today to implement the requirements of that Decision with respect to Operating Agreements, not to reexamine the legal underpinnings of the Decision itself, and we decline to be drawn into a debate more properly reserved for rehearing.

Sempra asserts that the proposed operating agreement and the fact that it contemplates an assignment of DWR’s rights and obligations under DWR’s long-term contract with SER (the “SER-DWR Contract”) violates the terms of that contract. Sempra cites Section 9.01 of the SER-DWR Contract, which states that:

Except for an assignment made pursuant to Section 9.02 [in connection with financings], neither Party shall assign this agreement or its rights hereunder without the prior written consent of the other Party, which consent may be withheld in the exercise of its sole discretion; provided however . . . . Department shall also have the right to transfer or assign (without relieving itself of liability hereunder) this Agreement to any electrical corporation, as defined in the Act; provided, however, that (A) such assignee is not an Affiliate of Seller;

(B) such assignee has credit rating equal to or higher than that of Department and a total capitalization equal to or greater than that of Seller and all of its Affiliates at the time of such assignment; (C) such assignee agrees to provide Seller with such credit assurances as Seller may reasonably require; (D) no such assignment shall be effective until Department shall have provided written notice to Seller of such assignment, which notice shall include the name and address of the assignee; (E) any such assignee shall agree in writing to be bound by the terms and conditions hereof; and (F) Department delivers such tax and enforceability assurance as the Seller may reasonably request. (Emphasis in original.)

As support for its position, Sempra argues that it has long been the rule in California that “if the contract itself provides in terms that it is not transferable, it certainly cannot be transferred, although it might otherwise be so.” *La Rue v. Groezinger*, 84 Cal. 281, 283 (1890); *Murphy v. Luthy Battery Co.*, 74 Cal. App. 68, 74-75 (1925) (“a contract is not to be held assignable where the parties expressly stipulate to the contrary”). “In the absence of a controlling statute the parties may provide that a contract right or duty is nontransferable. [Citations omitted.] Moreover, even when there is no explicit agreement — written or oral — that contractual duties shall be personal, courts will effectuate a presumed intent to that effect if the circumstances indicate that performance by a substituted person would be different from that contracted for.” *Masterson v. Sine*, 68 Cal. 2d 222, 230-31 (1968) (citations omitted); *accord Knipe v. Barkdull*, 222 Cal. App. 2d 547, 551 (1966) (“[w]here a contract calls for the skill, credit or other personal quality of the promisor, it is not assignable.”) (citation omitted); *see also Kreisher v. Mobil*.

Sempra states that not only is there no controlling statute that would permit the assignment or transfer of rights and obligations as contemplated by the Proposed Operating Agreement, but the law is to the contrary. According to Sempra, Pub. Util. Code § 454.5, requires only that the Commission “specify the

allocation of electricity, including the quantity, characteristics, and duration of electricity delivery, that the [DWR] shall provide under its power purchase agreements to the customers of each electrical corporation.”<sup>6</sup>

Sempra contends that DWR remains obligated not only to retain title to the power sold under the power purchase agreements but also to administer those agreements pursuant to Water Code Sections 80110 and 80260, as well as in accordance with the terms of its contracts with the energy suppliers. Sempra argues the law is clear and that DWR cannot do indirectly, by way of the Proposed Operating Agreement, that which it is forbidden to do directly under the terms of its long-term contracts.

The utilities join Sempra in arguing that the Commission cannot force the utilities to sign an operating agreement for two reasons. First, the utilities continue to assert that the Commission may not compel the utilities to accept assignment of DWR’s responsibilities under the Contracts because AB1X requires that DWR retain title to the energy it sells to the customers. Second, the utilities claim that under Pub. Util. Code § 454(c) the Commission may not approve a feature or mechanism for an electrical corporation if the feature or mechanism would impair restoration of an electric corporation’s creditworthiness.

In response, DWR points out that Sempra fails to note the authority provided to DWR under Water Code Section 80122(b). This Section authorizes DWR to engage in services determined by DWR to be necessary for the purposes of Division 27 of the Water Code. Section 80122(b) specifically provides that DWR may “engage the services of private parties to render professional and

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<sup>6</sup> Sempra Comments dated October 18, 2002, emphasis added.

technical assistance and advice and other services in carrying out the purposes of this division.”

Although DWR is correct, we need not rely on that authority in order to accomplish our goal herein. The Commission’s plenary authority under Pub. Util. Code § 701, in combination with the authority provided in Water Code Section 80106 (b) form the underpinning of this decision. In addition, as we stated in D.02-09-053, under current practice the utilities can and do accept allocation of DWR contract energy, albeit under a different operational framework, therefore, the requirement that DWR retain title to DWR contract energy in no way serves as a bar to allocation of operational control of the DWR Contracts.

In their comments on the Draft Decision, the utilities argue that they cannot perform the administration duties related to the DWR Contracts without an agreement with DWR that permits interaction between the utility and the selling party under the DWR Contracts. We clarify that our order only applies to the utilities. DWR remains legally and financially responsible for the DWR contracts, and is responsible for notifying the contract counterparties that the utilities will be operating as agents on behalf of DWR for the limited purposes of this Order. DWR is not subject to the Commission’s jurisdiction. Nevertheless, the Commission has been working closely with DWR to accomplish the desired transition of responsibility on January 1, 2003, and we expect that this cooperation will extend to the implementation of the adopted Operating Order.

## **V. The Role of the Commission and DWR**

The parties are sharply divided on the issue of the role DWR will take in determining the reasonableness of the utilities’ administration of the DWR

Contracts. In order to put the various issues addressed in this decision in context, we must first provide clarification as to the respective roles of the parties.

DWR recovers its costs through a revenue requirement that it submits to the Commission. The Rate Agreement (D.02-02-052) establishes the process whereby DWR recovers its revenue requirements from the customers of the utilities. Generally, DWR is required to submit updated revenue requirements on an annual basis or more frequently if needed, and is required to provide summaries of revenues and costs on a monthly basis. DWR is subject to the reporting requirements of the Rate Agreement, and also to the reporting requirements of the Trust Indenture, as bond issuer.

DWR is entitled to recover in electric rates its bond costs, power procurement costs, and other costs listed in Water Code Section 80134. DWR also has the authority to conduct a reasonableness review under Pub. Util. Code § 451<sup>7</sup> of the costs it seeks to recover in electric rates.

The Commission has the responsibility under Pub. Util. Code § 454.5 to “specify the allocation of DWR power to be included in each utility’s procurement plan.” As we asserted in D.02-09-053, the Commission also has the exclusive authority to review the utility’s administration of the contracts as part of the utility’s portfolio of resources under § 454.5.

In sum, as of January 1, 2003, DWR will: 1) retain legal and financial responsibility for the DWR contracts, 2) remain responsible for calculating the DWR revenue requirement and for submitting revenue requirements to the Commission, and 3) continue to service the bonds as issuer. DWR’s responsibilities do not extend to conducting a reasonableness review of the

utilities' portfolio dispatch decisions. That responsibility rests with the Commission.

## **VI. Modifications to The Operating Order**

The Operating Agreement contains a variety of provisions, some of which are in the main body of the agreement and others are located in Exhibits A through F to the agreement. The Operating Agreement describes and defines the duties of the utilities with respect to the operation and administration of the contracts (Section 4.01 and Exhibit A), including the management of gas tolling provisions (Exhibit B) and reporting requirements (Exhibit F). The Operating Agreement also establishes the duties of DWR (Section 5.01). The Operating Agreement includes provisions addressing the consequences of default (Section 7), limitations on liability (Section 10), the confidentiality of information (Section 11), audit rights (Section 12), and dispute resolution (Section 13).

The parties have agreed to many of the provisions in the agreement, but substantial disagreement remains. The Operating Order we approve is based on a modified version of the draft Operating Agreement attached to DWR's November 6, 2002, Memorandum (DWR's Draft). The language of the Operating Order has been changed from that found in DWR's Draft to reflect that the Commission is ordering the utilities to comply with the terms and conditions of an Operating Order. In addition, we have modified certain language in DWR's Draft to ensure that it properly reflects the direction provided by the Commission in D.02-09-053. DWR's Draft has also been modified in

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<sup>7</sup> Water Code Section 80110.

consideration of the parties' comments. Substantive changes to specific sections of the Operating Order are discussed below.

**A. Operational Allocation and Management of Power Purchase**

SDG&E objects to the statements in Sections 2.02, 4.01, 7.02, and 12.01 of DWR's Draft that would require the utilities' to undertake their duties or functions "on behalf of DWR." SDG&E believes this characterization leaves open the question as to the nature of the capacity in which the utility is undertaking these functions. SDG&E suggests that the relationship should be characterized as one involving the provision of professional services to DWR by a private party in carrying out the purposes of Division 27 of the Water Code.

This language first appeared in DWR's November 6, 2002 Draft. The memorandum attached to DWR's Draft did not explain the reason for the inclusion of the language. Lacking good reason for its inclusion, and considering SDG&E's request for its removal (though without accepting SDG&E's characterization of the utility/DWR relationship), the Draft Decision deleted this language.

In its comments on the Draft Decision, DWR recommends a clarification of the limited agency role. DWR suggests that the utilities' agency functions should be distinguished from the utilities' service provider functions. DWR agrees with the Draft Decision that the phrase "on behalf of DWR" is not necessary with respect to surplus energy trading activities, but would prefer that the Commission include the phrase "on behalf of DWR" with respect to all other functions.

With respect to surplus sales, DWR agrees with SDG&E that the utility's role is best described as that of a "service provider" as contemplated by Water Code § 80122.

Unfortunately, the service provider role function described in Water Code § 80122 refers to an arrangement voluntarily entered into between DWR and a private party and, so as "service provider" role under § 80122 (as opposed to a limited agency role under Code § 80106) is not appropriate in the context of an Operating Order.

In all other respects, DWR's clarification is reasonable. Consistent with the foregoing discussion, the Operating Order will now provide that the utilities will act "as a limited agent on behalf of DWR" for purposes of the Order. We believe that the "Limited Agency" definition appropriately reflects the nature of the capacity in which the utilities undertake these functions. We explicate this more in our comments on Limited Agency, below.

#### **B. Standard of Contract Management**

The last sentence of Section 2.02 is deleted. Section 2.02, entitled "Standard of Contract Management," would allow DWR, upon request by a utility, to provide a certificate to the utility stating that the utility is in compliance with the Order in all material respects. Since DWR would be providing such a certification without waiving its own right to review or challenge the utility's performance, the only apparent purpose of obtaining such certification appears to be an attempt to limit the Commission's ability to review the utilities' actions. Since DWR does not have authority for reviewing the utility's administration of the Contracts, we see no logical reason to retain this provision.

### **C. Term**

The utilities take issue with the termination provisions in the DWR's Draft. Of particular concern to the utilities is the provision that would allow the utility to terminate the agreement only after an event of default by DWR and DWR's failure to comply with a final, non-appealable adjudication of the matter relating to the event of default by a court of competent jurisdiction. The utilities state that this provision would require the utility to continue performing under the agreement even if DWR has defaulted under its contracts. They recommend that this provision be deleted.

SDG&E and PG&E also argue that they should be entitled to terminate the agreement if: (1) they incur material financial liabilities in accordance with their performance under the agreement, or (2) if the Commission authorizes a termination. SCE expressed concern regarding the absence of Commission termination rights under DWR's Draft.

The utilities' concerns regarding termination rights have become moot with the conversion from Operating Agreements into Operating Orders. Nevertheless, we modify Sections 2.02 and 7.03 of the Operating Order to allow the utilities to request Commission authority to terminate the order if they believe circumstances warrant such action. We address a similar concern in Section 7.03, which addresses consequences of a DWR Event of Default.

### **D. Limited Agency**

Section 3.01 clarifies that the utilities are acting as DWR's agent, for the limited purposes set forth in the Operating Order. The utilities acknowledge that a fundamental underpinning of the Operating Order is that they become, to a limited extent, agents of DWR for purposes of managing the DWR generating

assets within their portfolio of generating assets. They agree to act as limited agents for purposes of purchasing gas associated with the DWR contracts. They disagree with the provisions of DWR's Draft that would create a broader agency relationship.<sup>8</sup> According to SCE, an unlimited agency relationship would create conflicts with the utilities' primary fiduciary obligation to operate in the best interests of its ratepayers and shareholders. SDG& echoes this concern in its comments on the Draft Decision. SDG&E contends that "the Commission must inform the parties that the Operating Order does not permit a conflict to exist between any fiduciary duties running either to DWR or to ratepayers and shareholders. SDG&E's primary fiduciary obligation is to undertake its operational responsibilities, whether of its assets or of the allocated contracts, in the best interests of the utility's ratepayers and shareholders."

DWR would seem to be equally concerned about a broader agency relationship, albeit for a different reason than that set forth by SCE or SDG&E. DWR's concern is that if given a general agency, the utilities would (inadvertently or otherwise) encumber DWR in undesirable ways. Hence, the language in DWR's initial draft required the utility to operate as DWR's agent for the limited purposes set forth in the agreement. DWR states that the "agency" relationship stems directly from AB 1X. In response to the utilities' concerns, DWR has worked to eliminate any language that might suggest that the utilities were in a general "agency" role, and has consistently referred to the utilities' agency role as that of a "limited agent." As discussed in Section 2.01, above,

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<sup>8</sup> SCE October 18, 2002 Comments, page 3.

DWR now requests that the Operating Order direct the utilities to undertake their duties as a “limited agent on behalf of DWR”.

With the understanding that the limited agency role in no way expands the authority of DWR to direct the utilities’ activities, we find it reasonable to characterize the utilities as DWR’s limited agents. We echo the utilities’ concern about taking any action that might impede the utilities’ satisfaction of this fiduciary responsibility to ratepayers. We believe that, as modified, the Operating Order ensures that the utilities can honor their obligations to their ratepayers. We are unclear on precisely what “conflicts” SDG&E is anticipating amongst its various duties to ratepayers, DWR, and shareholders, but, in response to SDG&E’s comments emphasize that SDG&E’s duties to its ratepayers remain paramount. We are not inclined to elevate SDG&E’s duties to its shareholders above its duties to DWR, and so decline SDG&E’s request to do so if that was in fact, what SDG&E sought via its comments.

#### **E. Limited Duties of Utility**

Consistent with our discussion in Section X.B below, we modify Section 4.01 to reflect that the utilities will be responsible for settlements. A corresponding modification is also made to Section 5.01(c) of Article V.

#### **F. Term and Consequences of Default by DWR**

As discussed in Section 2.02, above, the utilities expressed concern that Section 7.03 would require the utilities to continue performance under the agreement if DWR has defaulted under its Contracts. They request that Section 7.03 be modified to delete the parenthetical and qualification pertaining

to DWR's failure to comply with a final, non-appealable adjudication of the matter relating to such event of default.

We have modified Section 2.02 to reflect that upon a DWR default, utilities may seek Commission termination of the Operating Order. With this added provision, there is no need to further modify Section 7.03. In the event of DWR default, and prior to a final, non-appealable adjudication of the matter, if the utilities believe there is good cause to terminate the order they may apply to the Commission for interim relief.

## **VII. Modifications to Exhibit A**

### **A. Annual and Quarterly Load and Resource Assessment Studies**

SDG&E proposes to offer utilities the option of providing Weekly Load and Resource Assessment Studies, in addition to the required Annual and Quarterly Studies. As the utilities always retain the option to provide information beyond that which is required, it is not necessary to specifically provide such an option.

### **B. Scheduling Protocols**

SDG&E also suggests adding a new subsection C.5 to Part I as follows: "In order to implement "least-cost dispatch" of resources subject to this Agreement, DWR and Utility shall develop acceptable dispatch protocols and procedures that will enable Utility to dispatch resources on a basis acceptable to DWR and Utility." SDG&E believes it is critical that DWR and the Utilities have a clear understanding of each party's understanding of the meaning of the phrase "least-cost dispatch" before each utility begins scheduling activities. SDG&E argues that failing to undertake this effort will lead to disagreements

that are best understood before scheduling activities begin. As discussed in Section V above, DWR is not responsible for reviewing the utilities' dispatch decisions, and as such should not be responsible for defining the phrase "least-cost dispatch". The relevant definition of least-cost dispatch is described in Section XI of this decision.

### **C. Independent System Operator (ISO) Ancillary Service Market**

Part II of the Operating Order would authorize the utility to develop protocols and procedures for the use of DWR Contracts for Ancillary Services, subject to DWR review.<sup>9</sup> It is not clear if the required review contemplates a one-time review of utility protocols, or an ongoing requirement. In PG&E's opinion, the reporting requirements expected by DWR for proving that a contract was used appropriately for Ancillary Services as opposed to energy would render the Ancillary Services option unusable. We agree. We are not opposed to DWR conducting a one-time review of the utilities' proposed protocols for the use of DWR Contracts for Ancillary Services, but we believe that requiring DWR review prior to each transaction would reduce the utilities flexibility in managing their integrated portfolio, potentially jeopardizing our goal of least-cost dispatch. We also note that the utilities should not assume that DWR review of any

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<sup>9</sup> To the extent DWR has already accounted for Ancillary Services in its Revenue Requirement, the utilities and their ratepayers should not have to pay twice for such services. The Draft Decision of ALJ Peter Allen in A.00-11-038, notes that DWR estimates its 2003 cost for providing Ancillary Services at approximately \$170 million. Consistent with the Draft Decision of ALJ Allen, we believe that the DWR Revenue Requirement should be adjusted to reflect that the utilities are responsible for the cost of providing Ancillary Services.

proposed protocols will substitute for Commission review of utility contract administration.

#### **D. Collateral For Surplus Sales**

SDG&E takes issue with the language in subsection C of Part III of the Operating Agreement which states “If Utility sells surplus Power to an entity that requires collateral, the cost and obligation to post such collateral shall be Utility’s responsibility.” SDG&E states that, in trading surplus energy arising from the DWR Contracts, if DWR is unable to provide the required collateral then the Utility may find that its utility retained generation (URG) resources and DWR allocated contracts cannot be traded into the same markets. Since the revenue stream from these surplus sales is to be pro-rated consistent with the Commission’s directive, SDG&E believes the utility’s customers may be “shorted” revenues as a result solely of DWR’s inability or unwillingness to provide and pay for any required collateral. In its comments on the Draft Decision, PG&E requests that, to the extent there are collateral requirements associated with sales of surplus power, DWR should be required to bear its pro-rata share of the costs. PG&E claims that since legal title, financial reporting and responsibility for the payment of contract related bills will remain with DWR, the cost of transferring title to property should be borne by DWR, not by PG&E.

SDG&E also claims that it would be unlawful for the Commission to compel a utility to provide its own credit facility at its own cost to support any trades of surplus energy from the allocated DWR contracts. PG&E agrees, and states that such a policy would be inconsistent with D.02-09-053 and State law vesting legal title to the contracts with DWR.

SDG&E also argues that the Commission would be committing legal error by shifting this responsibility to the utilities in the absence of a formal evidentiary process to ascertain the effects of such an obligation on each utility's creditworthiness. SDG&E's arguments seem related only to collateral for gas purchases,<sup>10</sup> though there is a tangential mention of credit support for surplus sales. Insofar as we have adopted the utilities' request the DWR rather than the utilities provide credit support for gas purchases,<sup>11</sup> these arguments are moot.

The utilities' other arguments appear to rely on the assumption that the provision of collateral in connection with surplus sales is a "right" under the contracts that may not be transferred. The provision of collateral is not a non-transferable "right" under the contracts. The collateral requirements at issue in Part III C are not imposed by the DWR Contracts, but rather by exogenous variables (e.g., the ISO Tariff). Collateral may be posted by the utilities without implicating the DWR Contract's provisions. Moreover, we do not find any likelihood of "shorting" of ratepayers by virtue of making the utilities rather than DWR responsible for posting collateral for all surplus sales. As far as we can see, ratepayers are indifferent to whether collateral costs come from DWR's or a utility's revenue requirement. SCE suggests that although ratepayers may be indifferent as to who provides the collateral, they would prefer that collateral be provided at the lowest possible cost. We find that in the long run, it does not

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<sup>10</sup> See SDG&E comments at pp.9-10, expressing concern about "...the volumes of gas related to the tolling provisions;" "...the DWR contracts allocated to SDG&E, which contain tolling provisions and as of July 1, 2002, amount to 1885 MW...;" "costs associated with collateral requirements to effect purchases of gas are not dealt with either in the Draft Servicing or Operating Orders."

<sup>11</sup> In Section VIII of this decision, below.

make sense to require DWR to continue to perform this activity. Consistent with our goal of reducing the utilities' reliance on the states' resources, we adopt DWR's proposed language. We clarify, however, that the utilities should have the opportunity to recover the reasonable costs associated with the provision of collateral pursuant to Section 8.01 of the Operating Order.

#### **E. Transition Period**

The three utilities support adding a provision to Section VII of Attachment 5 to Exhibit A to establish a six-month to one-year transition period, during which DWR would "facilitate, assist and cooperate with Utility in the transition from DWR to Utility of the performance of the operational, dispatch, and administrative functions as provided under the agreement."<sup>12</sup> During this "transition period," the utilities would not be subject to reasonableness review of their administration of the DWR Contracts.

While we understand the concern expressed by the utilities regarding a "cold-turkey" shift, we note that the utilities have been on notice since September 19, 2002 of which specific contracts they are responsible for. They have also had ample notice of the nature of this responsibility. Moreover, following release of this draft decision, there are still six weeks remaining before the proposed transition during which utility operators and schedulers continue to have access to DWR staff. Utility operators and schedulers can obtain from DWR staff needed information regarding individual contracts. Although we recognize that DWR has had experience operating these contracts, we do not believe its experience with dispatching the contracts on a statewide basis would

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<sup>12</sup> Ibid.

help the utilities with dispatch of three separate portfolios in January 2003. Currently, DWR uses a single portfolio to dispatch its resources to meet the utilities' net short. Starting in January 2003, the utilities will each have a separate portfolio to operate and will need to dispatch contracts in a least-cost manner to meet their individual loads. It is intuitive that operation and dispatch of contracts under three separate portfolios is sufficiently different from present practice to reduce the relevance of DWR's prior dispatching experience. And, although DWR has significant knowledge regarding individual contracts, we note that the State is in the process of renegotiating several of the contracts. This could lead to substantial changes in the way power is delivered under the contracts. In this case, again, DWR's experience would not be particularly helpful. Finally, there are certain contracts for which delivery has not yet begun, and will not begin until sometime after the utilities have taken over the dispatching responsibility. In this situation, DWR would not have either contract-specific experience or dispatching experience to offer.

We are not persuaded that DWR's continued involvement with the operation and dispatch of the contracts would benefit the utilities and their ratepayers. Ratepayers should not bear the cost associated with DWR continuing to staff a function for which DWR is no longer responsible. We note that DWR's Draft no longer contains this provision therefore no change is necessary.

### **VIII. Modifications to Fuel Management Protocols**

Under a number of the DWR Contracts, DWR has the right to provide gas for the generating units. These "gas tolling" provisions allow DWR to use the physical supply of natural gas to manage the risk of volatility of gas prices reflected in the Contracts. Since gas costs are generally passed-through under

the Contracts, the suppliers have few incentives to provide low-cost gas. Our evaluation of how DWR and the utilities should manage the contracts with gas tolling provisions relies upon the following principles adopted in D.02-09-053:

“Moreover, shifting responsibility for administration of gas purchases under gas tolling provisions furthers our goal of extricating DWR from day-to-day procurement activities. In sum, the utility’s operational and administrative responsibility for DWR contracts should extend to the implementation of gas tolling provisions (p. 48).”

The portion of the Operating Order addressing the gas tolling provisions is referred to as “Exhibit B,” titled “Fuel Management Protocols.” The purpose of this exhibit is to describe and define DWR’s and the utilities’ specific responsibilities regarding management of those aspects of the Contracts directly related to supplying gas to generators.

Consistent with our adopted principles, Section I of Exhibit B specifies that DWR will retain legal and financial responsibility for gas and related services whereas the utilities will perform the administrative and operational activities as a limited agent of DWR. Pursuant to Exhibit B, the utilities are responsible for preparing “Gas Supply Plans” detailing their strategies for procuring gas and proposed use of risk management instruments. These plans will set parameters under which the utilities will perform the various gas-related activities pursuant to the gas tolling provisions. The utilities shall file these plans for Commission approval through Advice Letter filings on a semi-annual basis. The Commission will review and approve these plans on an expedited basis. Following approval of the Gas Supply Plans, the utilities will negotiate with

suppliers for gas supplies, transportation, and storage. Negotiated agreements will then be submitted to DWR for execution.

SDG&E requests that the Commission clarify how it will approve the utilities' Gas Supply Plans in a timely manner. SDG&E is concerned that the utilities will be at risk for necessary modifications to the Gas Supply Plans during the gap between the semi-annual plan approval. Since the purpose of this approach is to provide the utilities with sufficient flexibility and authority to execute normal day-to-day activities in administering the fuel provisions of the gas tolling contracts, we believe that the Gas Supply Plans should incorporate proposed parameters under which the utilities could implement changes to the plans to reflect market changes.

In recognition of DWR's continuing legal and financial obligations, we believe it is appropriate for DWR to review the utilities' Gas Supply Plans. However, we find that some elements of Exhibit B of DWR's Draft extend DWR's area of control outside the acceptable scope and into the rightful domain of the utilities and the Commission. In particular, with respect to gas purchasing, transportation, storage and risk management, we believe DWR should limit its involvement to the review of the utility's Gas Supply Plans and that, following Commission approval of these plans, the utilities should be free to negotiate and present agreements for DWR execution without subsequent DWR approval. Specifically, in Sections V through VIII of Exhibit B, the utilities should not be required to submit the agreements to DWR for advance approval prior to execution if the Gas Supply Plans have already been approved

In Section XII, we provide that the utility should make the final decision related to the use of risk management tools after January 1, 2003. In addition,

since the utilities will be responsible for managing the gas tolling provisions of the contracts as of January 1, 2003, including the responsibility for managing gas price risk, they should take action immediately to determine the level of exposure and work with DWR to enter into any necessary forward hedges for the period beginning January 1, 2003. Due to the nature of price risk management tools, this will require entering into arrangements prior to January 1, 2003.

In its comments on the Draft Decision, DWR notes that it expects the utilities, as part of the Gas Supply Plans, to propose and implement hedging programs in recognition of the volatility of gas prices and the magnitude of DWR's exposure. DWR is concerned that the utilities' incentive to hedge independently is problematic because they are not responsible for gas costs and associated risks since these costs continue to flow to DWR and are included in the DWR revenue requirements. DWR also states that restrictions on the use of the State's credit and collateral and the existence of most favored nations language in the power purchase agreements prohibit use of DWR credit by the utilities to implement the hedging programs. DWR notes that it is not opposed to the utilities' conducting hedging activities, but that DWR will need to reserve the right to conduct its own hedging program to cover positions that remain open after review of the utility hedging programs. DWR also believes that the utilities should be free to negotiate contracts for hedging and submit them to DWR for execution.

SDG&E suggests several revisions to Exhibit B of DWR's Draft. First, in reference to Part II (Fuel Activities), SDG&E requests that DWR should state what credit requirements should apply for gas procurement from third parties. Second, SDG&E recommends that Part V (Gas Purchasing) specify that DWR is

responsible for meeting suppliers' credit requirements and providing all collateral under any gas contracts. Additionally, SDG&E argues that DWR should be required to notify the utilities of the availability of DWR collateral for use in fuel planning and proposals. Third, SDG&E states that it has reached agreement with DWR on a revision to Part IX (Managing Gas Delivery/Usage Imbalances that changes the utility's duty of care for gas imbalances from "prudent gas management practices" to "commercially reasonable gas management practices, consistent with Good Utility Practices."

In support of its recommendations, SDG&E suggests that DWR may find that it makes economic sense to provide collateral support for gas supply contracts. SDG&E requests clarification that the utilities are not obligated to provide their own credit facilities to support any gas purchasing activity.

PG&E agrees, and notes that in the Bankruptcy court motion filed by PG&E seeking authority to resume procurement, it requested authority to use a specific amount of cash to support its procurement activities. PG&E states that its request did not include potential collateral requirements associated with DWR gas purchases. PG&E agrees with SDG&E that the Commission should not require the utilities to use their collateral to support gas supply obligations incurred by DWR. We grant SDG&E and PG&E's request, and agree that DWR rather than the utilities should provide credit support for gas purchases related to the DWR contracts.

With the exception of the modification of Part IX, regarding the standard for contract management, we see no need to adopt these provisions. With respect to Part IX, we find that this change is consistent with the standard

of contract management described in Section 2.02, above, and should be approved.

Finally, we note a discrepancy between the procedures for paying gas invoices presented in Exhibit B of DWR's Draft and that described in D.02-09-053 (see page 50 and Conclusion of Law 9). At issue is what party should be responsible for paying suppliers. Exhibit B specifies that the utilities would review the invoices and forward them to DWR for payment whereas D.02-09-053 states that DWR would reimburse the utilities for any payments. We will adopt the payment procedures found mutually acceptable by the parties and specified in Sections X and XIV of Exhibit B.

#### **IX. Modifications to Settlement Principles for Remittances and Surplus Revenues**

D.02-09-053 adopted series of steps associated with the allocation of the DWR contracts to the utilities. Among other things, the decision directs the utilities to integrate the contracts into their respective portfolios, using a least-cost dispatch for the integrated generation portfolio, and, adopts pro rata approach to calculating surplus energy sales and revenues from an integrated utility portfolio by:

- “(1) calculating the amount of surplus sales based on the excess of total utility portfolio resources (including DWR contracts allocated today) relative to loads,
- “(2) allocating those sales revenues between DWR and the utilities based on the relative quantities dispatched from utility resources and the DWR contracts, and
- “(3) calculating the revenue from retail customers using the difference between dispatched quantities and the surplus sales quantities calculated under (2).”

## **A. Surplus Sales Quantity Determinations**

Exhibit C, titled Settlement Principles for Remittances and Surplus Revenues, describes the methodology used to calculate revenues associated with surplus sales from the utility's integrated portfolio and retail customer deliveries– utility remittances to DWR for DWR energy provided to retail customers. Formulas contained in each utility's and DWR's drafts follow a pro rata calculation, but each approach is different.

The most contentious set of issues revolves around the definition of surplus sales – determining what types of sales count as attributable to the utility's allocation of DWR contracts versus the rest of the utility's portfolio, and whether transaction costs and any penalties, adjustments and other costs associated with energy sold into the ISO market are net of the sale.

PG&E approaches the problem by first defining its total load obligations: retail load, existing energy exchange transactions, Western Area Power Administration (WAPA) load obligations, pumping load (such as Helms), and transmission and distribution losses. Surplus energy is defined as the difference of these obligations from the integrated portfolio of PG&E URG and its allocated DWR contracts. PG&E identifies the remainder as surplus energy for (A) wholesale bilateral sales not embedded in its current obligations, (B) energy sold to the ISO as instructed energy,<sup>13</sup> and (C) energy sold to the ISO as

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<sup>13</sup> ISO Instructed Energy occurs in real time to balance grid supply and load imbalances, where certain resources having spare capacity are able to sell energy to the ISO.

uninstructed energy.<sup>14</sup> DWR's surplus energy share would be this remainder multiplied by the percentage of DWR energy delivered to retail customers, hourly. PG&E's share would be the complement. Payments of surplus energy revenues would be made monthly, while remittances for retail customer deliveries would be made daily, as they are now made.

SDG&E's approach is similar to DWR's initial version of Exhibit C, but refines the definitions of what sales types are included or excluded from the pro rata calculations. SDG&E states that since it has no wholesale obligations, it defines Surplus Energy Quantity by subtracting its total retail customer load requirement from the sum of dispatched Utility Supply and dispatched DWR Supply. In general, the remainder forms the denominator for Surplus Sales.

However, due to anticipation of some restricted transmission and/or recognition of economic and operational efficiencies, where a resource-specific sale might avoid a high congestion charge, SDG&E identifies some exceptions under the category of resource-specific sales. These latter transactions would be excluded from the pro rata sharing formulas, and would be wholly attributed to either the utility or to DWR, depending on the resource.

SCE submits a proposal to add a new Attachment J to its existing servicing agreement with DWR, moving other parts of Exhibit C into Exhibit A. SCE submits that surplus energy sales emanate from the utility's integrated portfolio. SCE determines the quantity of deliveries to retail customers at the

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<sup>14</sup> Uninstructed Energy occurs when delivered energy and real-time demand are unequal.

meter. To SCE, all surplus sales are wholesale sales (exchanges, forward sales, ancillary services<sup>15</sup> and instructed deviations) and are excluded from the pro rata calculation. The only type of surplus sale that SCE would deem a “portfolio” surplus sale to be apportioned pro rata is a positive uninstructed deviation.<sup>16</sup> SCE would base its calculations of sales using ISO Settlements data.

SCE would identify surplus sales after 1-1-03 as tied to a specific resource. Resource-specific sales quantities and revenues would be separated, and the revenues net of transaction costs would be directed to either SCE or DWR, respectively, depending on the resource. For SCE, resource specific sales could occur due to restricted transmission and/or a condition where it is more economic to sell power from an out-of-area resource than to import the power. Sales of Ancillary Services Capacity bid to the ISO would be classified as a resource-specific sale. However, existing exchanges on or prior to 9-19-02 would constitute a utility URG-only sale and any new exchanges would be made from the utility’s URG.

SCE disagrees that any forward sale of surplus energy should be approved by DWR, and instead would incorporate a plan for surplus sales in its Procurement Plans submitted to the Commission for approval. SCE would provide DWR with any executed sales transactions at the time such submittals are required. As such, SCE requires DWR to provide collateral supporting any

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<sup>15</sup> Ancillary Services are ISO transactions where capacity from certain resources is used to provide grid reliability rather than energy to be sold in the market.

<sup>16</sup> Positive Uninstructed Deviations occur when scheduled energy exceeds demand. The energy is sold to the ISO market. Negative Uninstructed Deviations occur when demand exceeds scheduled supply.

forward portfolio sale where the purchaser of the forward sale requires such collateral.

The utilities agree that revenues from any surplus sales made would be net of the transaction costs. This would include brokerage fees, transportation fees and losses. The utilities also net out any adjustments and penalties and other costs for energy sold into the ISO.

In response to the Parties, DWR's Exhibit C (dated 11-6-02) evolved into a more complex description based on dispatched quantities of URG and the allocated contracts. DWR's position is to isolate transactions related to retail load. DWR adjusts both the total URG and the DWR allocated contract dispatched quantities to exclude ISO Instructed Energy, Ancillary Service sales and transmission losses. In addition, the URG quantity would exclude any exchanges, and any existing, non-retail obligations in effect before the effective date of the Operating Order. DWR would also exclude from the URG quantity any forward sale delivery obligation based on a URG resource. But a sale from a DWR allocated contract for a period in excess of 30 days, requires DWR's express approval. DWR would permit a resource-specific sale of a DWR allocated contract's surplus energy under conditions of unavailable transmission or uneconomic congestion charges, subject to DWR approval.

The resulting quantity, including positive ISO Uninstructed load deviations,<sup>17</sup> less retail load, represents the total surplus energy quantity.

### **Resource-Specific Sales**

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<sup>17</sup> This condition exists when scheduled supply exceeds metered demand.

SDG&E identifies certain energy and capacity transactions as resource-specific, tying sales of some surplus energy and the resulting revenues to the resource providing the additional energy. SDG&E would exclude a resource-specific sale from the portfolio, if it is excluded from the ISO schedule for serving retail load. Otherwise, such a sale would be included in the portfolio and would be treated as a forward sale. PG&E prefers to add all sales transactions, including forward sales and resource-specific sales but excluding Direct Access, into the pro rata calculation. SCE's position is that surplus sales and revenues are resource-specific, and the associated quantities, revenues and transaction costs should be tied to the resource. DWR's position is that resource-specific sales can be included in surplus calculations as a pro rata sale where transmission is unavailable or if it is more economic to sell due to high congestion charges. However, DWR insists that it must approve such a sale if it exceeds 30 days, similar to a forward sale, if a DWR contract is involved.

Variants of a resource-specific sale are Ancillary Services and ISO Instructed energy. Ancillary services are transactions where capacity from certain resources is sold to the ISO for ancillary services rather than being used as energy to serve retail load. Similarly, ISO instructed energy is a transaction where certain resources are able to sell energy from unused capacity into the ISO in the real time market to balance supply and load imbalances on the grid. Resources from both the utility portfolio and DWR Contracts may qualify for use as Ancillary services and/or ISO instructed energy. These "sales" are resource-specific, and most parties agree that they should be excluded from the pro rata calculation. Should revenues or quantities accrue due to Ancillary Services and ISO Instructed energy, they should be tied to and returned to the resource. Only PG&E would include them.

### **Exchanges**

Exchanges of energy are defined by SDG&E as “transactions where energy is delivered to a third party in one period and a similar, but not necessarily equal, amount of energy is returned by the third party in a different period.” DWR would not allow exchanges of DWR Allocated Contracts, and would instead consider this to be a URG transaction. PG&E would include an exchange as a URG purchase for incoming and as a part of its total energy obligations as outgoing. SCE recommends that exchanges be treated as utility supply due to the complexity of tracking energy inbound and outbound. SDG&E considers exchanges as portfolio transactions to be shared pro rata, where outbound energy is treated as a forward sale, with the supply receipt shared pro rata based on the relative supplies originally sent.

### **Forward Sales**

Forward Sales can occur shortly before a schedule is submitted to the ISO or for a longer period of time such as 30 days into the future. DWR proposes to include forward sales in the calculation of surplus sales if the sale emanates from an Allocated Contract, but requires the ability to approve any forward sale from an Allocated Contract extending longer than 30 days. DWR would allow the utility to sell URG without any approval, but the forward sale would be excluded from the pro rata surplus calculation.

### **Negative Surplus Sales**

Negative Surplus Sales Amounts occur when the sales of surplus energy results in a cost. PG&E and DWR agree that any negative surplus sales amounts (negative price) are attributed to the integrated portfolio, and define these amounts as overgeneration conditions. SCE also envisions overgeneration

as a “portfolio” sale, but defines the term further as paying the buyer to take energy. Negative price amounts occur when the sales of surplus energy results in a cost, and these quantities and sales would be calculated pro rata.

### **Discussion**

We have reviewed the parties’ positions and that of DWR, and appreciate the detail and efforts all have shown in this negotiation process. Although PG&E’s position is the most straightforward, and SCE’s proposal for resource-specific sales has some merit, we believe that the approach proposed by SDG&E on October 23, 2002 best serves to equitably integrate and adjust the surplus sales quantities between the utilities’ portfolios and the DWR Contracts.

Under D.02-09-053, we have directed the utilities to integrate the DWR Contracts into their respective generation portfolios and to resume the scheduling and operation of electricity transmission through the ISO. The hourly scheduling will be done on a least-cost dispatch of the integrated portfolio. The utility’s scheduling also entails consideration of time and supply sensitive energy, available capacity and transmission constraints. All scheduling is made in recognition of forecast demand. The objective is to economically manage a portfolio of resources dedicated to meeting loads following a least-cost dispatch, while efficiently balancing the schedules to ensure grid reliability. We recognize that hourly operational decisions must be made in advance and in real time. Also, at times, more energy might be available than is either scheduled or demanded, causing conditions of surplus sales or overgeneration.

In consideration of the circumstances leading to periods of surplus energy, we will define surplus energy as a condition where dispatched supply

from the utility's integrated portfolio occurs in excess of loads. Loads include retail load and existing utility non-retail loads and obligations.

We find that some resource-specific sales, exchanges, forward sales and negative surplus sales should be recognized under our definition of what constitutes a surplus sale. While these sales types are exceptions to the more usual type of surplus sales, all surplus sales should be made net of transaction costs, including transmission and brokerage costs, losses, and other related costs and penalties. We decline to adopt SCE's recommendation for a broad exclusion for all resource-specific sales because it represents a significant departure from the pro rata sharing policy adopted in D.02-09-053. This policy was adopted, in part, to counterbalance the utilities' incentive to dispatch utility resources first, leaving DWR resources to be sold as surplus. Therefore, although we recognize that it is indeed possible to identify which specific resources have been dispatched at any point in time and to designate the last resources dispatched as surplus, we find that the proposal conflicts with the policy goals delineated in D.02-09-053 and we reject it.

We will approve an exception with respect to Ancillary Services or ISO Instructed Energy, however, because there is less utility discretion involved in which resources are scheduled and, as a result, less potential for gaming. Where a resource provides Ancillary Services or ISO Instructed Energy, the quantities and net revenues should be tied to the resource and excluded from pro rata sharing.

Exchanges allow available supplies to be optimized under the utility's integrated portfolio. As identified by SDG&E, exchanges are portfolio transactions, but are not necessarily equal quantities sent and received. We agree

with SCE that due to the complexity of tracking utility and DWR power that is outbound and inbound on an hourly basis, the source of generation for exchanges should be counted as URG in the pro rata calculation.

We agree with DWR that forward sales should be included in the pro rata calculation if the sales emanate from a DWR Contract. However, we disagree that the utilities should consult with DWR before executing the forward sale of a DWR allocated contract quantity made in excess of 30 days. We see no reason for DWR to approve any forward sale. All forward sales should be included in the pro rata calculation.

Negative surplus sales are a distinct possibility under today's demand conditions. We recognize that these sales will produce a negative price and therefore, will be distributed pro rata.

We allow the exceptions of certain resource-specific sales, exchanges, and forward sales to occur in order to allow the utilities to optimize their portfolio resources. However, we require a paper trail of these transactions to review for reasonableness. The utilities shall report instances of these identified exceptions in the Procurement Plans filed pursuant to D.02-10-062, with an explanation of the circumstances surrounding the surplus sale. In their comments on the Draft Decision, PG&E requests that the Commission clarify that surplus sales will be made under the utilities procurement plan. PG&E notes that the obligation to sell surplus power is potentially the most significant challenge and risk imposed by the Draft Decision.<sup>18</sup> PG&E states that the decision lacks

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<sup>18</sup>PG&E Comments dated December 9, 2002, page 10.

guidance on how the Commission will review the manner in which the utilities manage the surplus sales. PG&E request that the Commission modify the Draft Decision to clarify that surplus sales will be sold under the utility's procurement plan and not be subject to after the fact reasonableness review as provided in the utility's procurement plan. PG&E suggests that the utilities be allowed to propose sales strategies for surplus power through Advice Letters intended to update its procurement plans.

PG&E's request appears to be simply an unnecessary and untimely attempt to avoid Commission review of contract administration. In D.02-09-053, the Commission adopted a pro rata approach to calculating surplus energy sales and revenues from an integrated utility portfolio. This decision clarifies the definitions related to surplus sales. This decision also provides the necessary guidance regarding how the Commission will review the utilities actions with respect to surplus sales. PG&E's suggestion that the Commission and the parties revisit the surplus sales policy is rejected.

We have adapted SDG&E's rewritten version of Exhibit C dated October 23, 2002, but have inserted PG&E's initial methodology of defining its total load obligations, in order to capture all load that is met by the utilities' portfolios, including WAPA,<sup>19</sup> and to make the operating agreements more responsive to PG&E and SCE's concerns. As identified below and later under Exhibit F, we also modify Exhibit C to comply with D.02-09-063 for the utility's role of performing the settlement function.

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<sup>19</sup> PG&E retail load obligations per CPUC May 2002 Service Order (D.02-05-048) includes WAPA load, although this is not retail load.

## **B. Settlements**

D.02-09-053 defines the role of the utilities with regard to performing the settlement functions, where "...DWR will be financially responsible for paying all contract-related bills. However, as DWR points out, this does not require that DWR staff and consultants continue to perform the billing and collection "settlement" function for those contracts. Rather, we expect the utilities to assume these activities for the DWR contracts as they resume the same settlement functions for new procurements." (D.02-09-053, *mimeo*, p. 47.) Also, "... the utilities should perform all of the day-to-day scheduling and dispatch functions for the DWR contracts allocated to their portfolios, just as they will perform these functions for their existing resources and new procurements. This includes performing the billing and collection "settlement" functions for DWR contracts, and verifying all invoices." (D.02-09-053, FoF 30, *mimeo*., p. 67.) Exhibit C (DWR Version 11/6/02) outlines bilateral settlement functions to be maintained by DWR, but not the utilities. However, Exhibit C would require the utilities to do the scheduling, but forward all of the hourly ISO scheduling statements to DWR to validate the payment of generator invoices, among other processes.

DWR states that existence of a "strong and well-defined settlements methodology, which is consistent with both AB1X and the Contract Allocation decision, allows DWR to have much less involvement in operational aspects of managing the contracts (e. g., forecasting, scheduling, surplus sales).<sup>20</sup>"

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<sup>20</sup> DWR Memorandum dated October 8, 2002.

SCE described the current process as follows: “SCE will perform the settlement function for DWR contracts to permit DWR to determine the amount of payment to be paid under the DWR contracts allocated to SCE. DWR will then completely duplicate that settlement process. This “shadow” settlement process will be the settlement process that DWR relies upon for purposes of payment. To accomplish the shadow settlement function, DWR is requesting under Exhibit F of the Operating Agreement that the utility provide it with essentially all of the information that the utility employees collect to complete the settlement process.”<sup>21</sup>

We have already acknowledged that, as financial obligor under the contracts, DWR will continue to be responsible for payment of contract-related bills. However, we believe that it is most efficient to shift responsibility for settlements to the utilities as they resume procurement. As stated above, our goal is to return to the utilities the responsibility for all the duties and functions associated with serving their customers. As such, we should not permit the utilities to continue to rely on the support of the State to perform duties that, in the long-term, should be their responsibility.

Exhibit F below directs the utilities to provide the information necessary to validate such invoices. Given that DWR will continue to have access to information sufficient to validate payments, we see no benefit in delaying the transfer of this responsibility.

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<sup>21</sup> November 8, 2002 Comments of SCE on Supplemental Filing of DWR.

We note however, that DWR's assertion of the need for duplicate settlement data is not required for purposes of payment of fuel and fuel transportation obligations or for ISO settlements. The procedure for fuel-related and ISO settlements permits the utilities to provide a settlement statement to DWR and advise DWR of its accuracy, which DWR will rely upon for purposes of payment. That procedure should be followed for energy sales as well. The settlement function is part and parcel of administering an integrated portfolio. Allowing the utilities to shift the responsibility for settlements to DWR would hinder our goal of extricating DWR from the day-to-day portfolio management activities. It would also be duplicative. As SCE points out: "DWR wants a utility to perform the settlement process and then send DWR the data so that they can duplicate the settlement process. Ratepayers will presumably be required to pay twice for such duplicative services by means of DWR's revenue requirement."<sup>22</sup> In sum, the utility's operational and administrative responsibilities should extend to include the settlements function.

### **C. ISO Charges**

DWR believes that the transition of responsibility for the residual net short to the utilities, the utilities responsibility to make operating decisions as to the utilization of the contracts as DWR's agent, and a goal of simplicity, all dictate that responsibility for the ISO charges should revert to the utilities. In DWR's view, responsibility for ISO charges goes hand in hand with the responsibility for scheduling the power. DWR also notes that this view is

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<sup>22</sup> Reply Comments of SCE on DWR Agreements, dated October 23, 2002.

consistent with the fact that the existing arrangements for ISO costs expire at the end of December 2002.

We agree that the responsibility for ISO Charges should revert back to the utilities as of January 1, 2003. Although certain ISO charges may be resource-specific there is no reason why the utilities should not be held responsible for them. Presumably, the ISO charges would not occur were the utility not scheduling power to meet its obligation to serve its customers. Responsibility for all ISO Charges associated with serving the utilities customers belongs with the utilities, consistent with their obligation to serve those customers.

SDG&E notes that if the utilities are responsible for ISO charges, and such costs are already included in DWR's revenue requirement, ratepayers would be charged twice for ISO costs. SDG&E recommends that Exhibit D be modified to reflect that the utilities' obligation to pay for ISO charges should not result in double recovery of these costs. We agree.

## **X. Modifications to Reporting Requirements**

DWR filed an Exhibit F on October 23, and later modified it to reflect changes resulting from its review of the utilities' written filings and its discussions with the utilities. DWR's draft delineates the data to be provided to DWR by the utilities and the frequency and timing for providing such information. DWR requires information on several categories including, contracts/trade, schedule, ISO settlements, fuel costs, revenue remittance, and resource information.

To provide further information to the Commission and the Utilities, DWR submitted an attachment with the mapping of its data requirements to

Exhibit F, outlining the functions (for example, revenue requirements, validation of revenue remittances, rate agreement reporting, bond management, and fiscal management reporting) for which DWR requests information.

SDG&E also filed an Exhibit F on October 23 and submitted further revisions for the Commission to consider through its November 6 motion. PG&E filed an Exhibit F on October 23, but did not file a revised version on November 6. Edison filed revisions to its Servicing Order on October 23, 2002. Section 8 of SCE's proposal refers to audit rights and records, but does not specifically address data requirements

In reviewing Exhibit F, we rely on three principles. First, the purpose of Exhibit F should be to establish mechanism under which DWR can obtain the data it needs to fulfill its legal and financial obligation under the long-term contracts consistent with D.02-09-053. Information that DWR needs to fulfill its other obligations, for example, under the bond indenture, should be provided for as directed by the Servicing Arrangements.

Second, as described in Section V above, the CPUC, not DWR, is responsible for reviewing the utilities' dispatch decisions; therefore, access to information intended solely to be used for validation of least-cost dispatch by DWR is unnecessary. SCE, in its reply comments filed on November 8, states its concern about the role of DWR with respect to review of the utility dispatch decisions. SCE is concerned that it could comply with "least-cost dispatch" under the Commission guidelines, but could find itself in noncompliance under DWR's process. We share these concerns. This decision adopts up-front standards under which the Commission will evaluate utility administration and management of the DWR Contracts. An independent review of the utilities'

dispatch decision by DWR would be duplicative and would create confusion for the Utilities. DWR has the option to participate in our proceeding if it believes the Commission will benefit from its input in determining the reasonableness of the utilities' dispatch decisions.

The reporting requirements should be efficient and, to the extent possible, avoid creating new reports or procedures. The requirements should be narrowly tailored to implement the procedures adopted in this decision. In particular, we want to avoid duplicating any reporting requirements that already exist as a result of the Rate Agreement (D.02-02-052), the Bond Indenture, or the Servicing Arrangements.

It would be a waste of the state's resources if DWR duplicates the Commission's efforts and engages in reviewing the day-to-day operational, dispatch, and administrative activities of the utilities with respect to the DWR Contracts. DWR's role should be to establish and validate the process by which the Utilities provide data to DWR. DWR's data requirements should be consistent with its role.

## **Review of Components of Exhibit F**

### **Schedule**

As stated in D.02-09-053, DWR will remain financially liable for the contracts and will continue to pay suppliers under the terms of the allocated contracts. DWR needs standard, reliable, and timely information from the utilities to fulfill its obligation. However, this obligation does not require with respect to the DWR contracts that the utilities share information about their entire portfolio with DWR. Currently, we believe DWR's reporting requirement goes beyond what is needed for DWR to perform its financial obligation for allocated contracts and is inconsistent with D.02-09-053.

This inconsistency is clearly presented in DWR's November 6, 2002 filing, in which, DWR states that the information from the utilities "will be used to support bilateral contract settlements, validation of ISO Settlements, allocation, validation and payment of fuel procurement provided by the Utility, revenue requirement management and various ongoing reporting."

We realize that DWR has agreed to and has obtained PG&E's and SDG&E's agreements to perform all settlement related functions for the allocated contracts. However, as we discussed under Exhibit C above, we believe that the settlement functions should stay with the entity responsible for scheduling.

Therefore, any information in Exhibit F intended only to allow DWR to perform the settlement function is unnecessary, and should be deleted. However, DWR's mapping chart does not explain specific information is used in establishing a specific report. Therefore, we cannot easily identify from DWR's

filing what information will need to be eliminated if the utilities perform settlements.

Furthermore, it is not clear why DWR is not using a parallel treatment for gas cost. Under DWR's proposed procedure for payment of gas costs, DWR relies on the utilities to verify and provide a settlement statement. It is not clear why DWR relies on the utilities to review and approve invoices for payments of gas costs,<sup>23</sup> but does not extend the same treatment to the utilities with respect to the electric costs incurred under the contracts. We would prefer that the same procedure should be followed for both gas and electric costs.

In its December 16, 2002, comments on the Draft Decision, DWR explains that the summary data that the Draft Decision would provide does not provide sufficient information to allow DWR to monitor the utilities contract compliance or establish its revenue requirements. Other parties have inconsistent positions with respect to the type of information needed by DWR. SDG&E supports most of Exhibit F of DWR's Draft, including DWR's continuation of performing settlement functions. PG&E also supports DWR performing the settlement functions, but disagrees with certain reporting requirements requested by DWR.

In Exhibit C of its filing, PG&E states that:

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<sup>23</sup> DWR's 11-6-02 proposal. Section XIV of Exhibit B. For natural gas, pipeline transportation and storage services provided under DWR contracts and administered by Utility on behalf of DWR, DWR shall pay invoices from suppliers after they have been reviewed and approved for payment by Utility.

“DWR requires sufficient information to support payment request so that it can meet the accountability requirements of the State’s Controller’s office and the State Auditor, and simultaneously comply with the applicable statutes concerning disbursement of public monies. For these reasons, DWR shall retain the ability and responsibility to calculate bilateral settlements with Contract counter parties and make the associated payments to suppliers, and Utility will provide the data as required in Exhibit F to allow it to perform these duties in a timely manner as set forth herein.”

But in Exhibit F, PG&E offers to only provide DWR with load and resource information that is required to submit to the CPUC as part of the Procurement proceeding and certain scheduling information that it submits in its day-to-day interactions with the ISO. PG&E recommends that in Exhibit F, page F-1, all entries under “Schedule” should be deleted<sup>24</sup> as does SDG&E.<sup>25</sup> In its reply comments, SCE states that “...it has yet to have an opportunity to receive and explanation from DWR as to the reasons for the data requirements demanded.

Based on what the parties have provided us, we conclude that the some of the detailed daily information requested by DWR and outlined under the category of “Schedule “ in Exhibit F, are the types of information necessary for settlement-related functions, and could be eliminated if DWR does not perform those functions. However, in its reply comments, DWR notes that, although the utilities, not DWR, will perform the settlements functions, DWR will need to engage in settlements validations, audit, and monitoring to meet its legal and

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<sup>24</sup> PG&E Comments dated 12-9-02, page 14.

<sup>25</sup> SDG&E Comments dated 12-9-02, page 13.

financial obligations. It appears that DWR desires this information to duplicate the utilities' determination of the amount to be paid under the contracts.

DWR's reply comments provide additional clarifications regarding the need for certain information. DWR notes that some contracts settle on meter volumes while others settle on either hour-ahead schedules or final daily volumes, therefore, in order to validate and authorize payment on bilateral invoices forwarded from the utilities, DWR requests "Final Daily Schedule Volumes" for all allocated long-term contracts and any surplus energy sales, in addition to final hour-ahead volumes. DWR also requests that the information include transaction level detail that is not provided in the ISO templates. Although we believe that DWR should be able to rely on the monthly invoice and supporting documentation for bilateral contracts provided in the "Reconciled Monthly bilateral invoices schedule volumes" report to perform its validation, audit, and monitoring duties, we will modify Exhibit F to require the utilities to provide the additional information.

### **Remittances**

DWR is also requesting a number of reports related to customer bills under this category. PG&E, in its comments, identifies certain information requested by DWR, which is not available to PG&E or is not currently included in its customers' bills. In addition, DWR itself has identified data that it does not currently have access to, but expects to receive from the utilities in the future. It is not clear why DWR needs this additional information for revenue remittances. We deny DWR's request as outlined in our Exhibit F.

### **Resource Information**

DWR is also requesting a series of information related to load and resources including unit capacity, variable cost unit, and derate by unit. DWR is requesting this information for “planning purposes.” From the utilization matrix provided for Exhibit F, it appears that most of the information in this category is used for revenue remittance verification, and a few are used for revenue requirement. However, we will grant DWR’s request with the understanding that the reporting requirements will be reviewed and modified at least annually to eliminate unnecessary requirements.

### **XI. Proposed Standards for Reasonableness Review**

Part of our mandate in this decision is to adopt up-front reasonableness standards for utility administration of DWR contracts. In D.02-09-053, we stated that “The reasonableness of the utilities’ administration of the DWR contracts we allocate today, including how they elect to dispatch the contract power quantities relative to other resources in their portfolio, should be at issue over the life of the contracts”. We also stated that the forum for this review should be the annual procurement proceedings, where compliance with the adopted procurement plans is reviewed as a whole.<sup>26</sup> Subsequent to D.02-09-053, we approved D.02-10-062, which adopts specific standards for utility behavior with respect to utility procurement and contract administration. PG&E, SDG&E, SCE and Aglet each filed proposed standards. We have reviewed the various proposals in light of the policy direction provided in D.02-09-053, D.02-10-062, and the language in

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<sup>26</sup> D.02-09-053, mimeo. p. 7.

AB 57, Section 1, (d) that directs the Commission to “assure that each electrical corporation optimizes the value of its overall supply portfolio, including DWR contracts and procurement pursuant to Section 454.5 of the Public Utilities Code, for the benefit of its bundled service customers,” and finally in light of the language of § 454.5(d)(2). Since the intent of the Commission’s compliance review will be to ensure that the utilities “optimize” the value of the overall supply portfolio, the standards adopted herein should be consistent with those adopted in D.02-10-062.

The utilities’ proposed standards generally seek to limit the Commission’s review of utility activities related to the DWR Contracts. The utilities’ proposals range from limiting the time periods during which the utilities would be subject to review to limiting the areas of review or the amount of potential disallowance. For example, the utilities recommend that the Commission adopt a one-year “learning curve” period during which time utilities contract administration activities would not be subject to disallowances. PG&E’s rationale, which is consistent with that of the other utilities, is as follows:

“Given 1) the complexity of the DWR contracts, 2) the lack of consistency in interpretation of the allocated DWR contracts, 3) the ongoing disputes between DWR and contract counterparties, and 4) the utilities’ lack of familiarity with the DWR contracts from an operational, settlements and administrative perspective, it is reasonable to establish a one year transition that ensures continued reliability and provides for a “learning curve” period. During this transition, the utilities will develop a full understanding of the contracts and operate and administer the contracts in parallel with DWR to ensure consistency in approach. During this transition, the utilities’ administration, operation, scheduling and dispatch of DWR contracts will not be subject to reasonableness review or disallowances of any kind by the Commission, except in the

event of gross incompetence, fraud, willful violation of contract terms or similar grounds.” (PG&E Comments 10-8, p. 13.)

We believe this recommendation is flawed for several reasons. From a policy perspective, it is inappropriate to allow the utilities to “practice” with ratepayer funds. Parallel operation will require the ratepayers to pay twice for DWR contract administration during the transition period. The record does not identify the cost associated with this parallel activity, but DWR’s comments referencing consultation with its outside counsel, accountants, financial advisors, contractors and consultants, not to mention DWR staff, in the preparation of DWR’s comments on the Draft Decision suggest that the cost could be significant.

In addition, from a legal perspective, the Commission is already bound by the requirements of AB 57 with respect to ensuring that utilities optimize the resources in their integrated portfolio for the benefit of ratepayers, and as such, we cannot excuse the utilities from review. In addition, as discussed in Exhibit C, above, the utilities have had ample notice of the nature and timing of this responsibility. They should be reasonably well versed in the asserted “complexity” of the DWR contracts by the time they commence administration of those contracts. In addition, as discussed in more detail below, the asserted “familiarity” that DWR brings to bear is not so substantial as the foregoing excerpt suggests.

The utilities also seek to limit the Commission’s review by arguing that an after-the-fact reasonableness review of the utilities’ administration, operation, scheduling, and dispatch decisions is prohibited by AB 57 and SB 1976. Despite the clear language in D.02-09-053, the utilities continue to argue that the scope of review of contract administration permitted under AB 57 is very narrow and

involves only a review of whether utility actions were conducted in accordance with the terms of the contracts.

The utilities interpret Pub. Util. Code § 454.5(d)(2) to state that after-the-fact reasonableness reviews of a utility's actions are prohibited with one exception: "the Commission may establish a regulatory process to verify and assure that each contract was administered in accordance with the terms of the contract, and contract disputes which may arise are reasonably resolved." Under this interpretation, the utilities contend that as long as the utilities do not violate the terms of the DWR Contracts in the exercise of their contract administration duties, AB 57 does not authorize the Commission to disallow costs. As support for this position, PG&E states that the Commission recognized this requirement in D.02-09-053:<sup>27</sup>

The Commission cannot determine that some portion of DWR's Revenue Requirement is not just and reasonable and must be borne by shareholders, without running afoul of Water Code Section 80110. In fulfilling our legislative mandate to review the reasonableness of the utilities' administration of the DWR contracts (including the gas tolling provisions thereof), we are constrained by the fact that this Commission cannot deny DWR recovery of its reasonable costs. (D.02-09-053, p. 54.)

What PG&E neglects to acknowledge, however, is that D.02-09-053 goes on to state that the review contemplated [by D.02-09-053] would not impact DWR's revenue requirement (*mimeo.* at p. 55). Although AB1X limits the Commission's role with respect to determining the justness and reasonableness of DWR's revenue requirement, it does not limit the Commission's ability to regulate the

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<sup>27</sup> PG&E 10-8.

utilities. The decision further states that “the Public Utilities Code Section process established by this Decision will be devoted to allocating costs between ratepayers and shareholders, without impacting DWR revenues.” In this decision, we reaffirm that; consistent with AB1X and our direction in D.02-09-053, the reasonableness of the contracts themselves will not be at issue in this proceeding. To the extent there is any confusion, we clarify that it is only the utility’s administration of the DWR Contracts that will be subject to our review.

Furthermore, what the utilities fail to mention is that up-front standards are meaningless if there is no opportunity to assess compliance with the standards. The Legislature and the Commission have succeeded in eliminating the need for traditional ECAC-type reasonableness review. The adoption of the utilities’ procurement plans eliminates the need to conduct traditional reasonableness review of the utilities’ activities related to procurement. Instead, consistent with the requirements of AB 57 and SB 1976, the Commission will approve the utilities procurement plans, including up-front standards of minimum behavior, and will conduct compliance review to evaluate utility compliance. The Commission has also provided guidance as to the nature of the compliance reviews contemplated in the Draft Decision.

Their position on the legality of reasonableness reviews notwithstanding, SDG&E takes the position that the primary standard by which the Commission should evaluate the utilities’ administration of the Contracts should come from an approved Operating Agreement. SDG&E proposes a standard whereby utility actions taken in conformity with the terms of an Operating Agreement would be deemed reasonable.

Similarly, PG&E proposes that the Commission find that to the extent the utility is directed by DWR to administer, operate, schedule or dispatch a DWR

Contract in a certain manner, such utility performance shall be deemed reasonable and that any and all costs incurred by DWR directly or indirectly under the DWR Contracts will be exempt from review. SDG&E and PG&E believe that the Commission has already acknowledged the logic of these approaches in D.02-09-053, by stating that it would be “hard pressed to imagine a scenario in which DWR orders a utility to take some actions, only to have this Commission find that the utility acted unreasonably”<sup>28</sup>. They recommend that, to the extent that DWR directs the utilities to administer the allocated DWR contracts in a specific way or has otherwise approved the utilities’ actions, such utility actions should be per se reasonable and exempt from Commission reasonableness review. In their view, the Commission’s separate review of utility contract administration under the procurement plans is potentially redundant and, may conflict with DWR standards.

SCE takes an opposing position and requests that the Commission affirm that DWR does not have any review authority over the utilities’ actions and that any obligations SCE may have to DWR with respect to administration of the contracts will be enforced by the Commission. SCE takes issue with the provision in DWR’s Draft that would allow DWR to review and participate in the utility’s decision-making for its system. SCE acknowledges its obligations to ratepayers, as well as the Commission’s, and maintains that those obligations should not be compromised by conflicting oversight and control.

In its reply comments, DWR requests that the Commission clarify the scope of the Commission’s regulatory review under Public Utilities Code Section 454.5. DWR states that it is not clear whether the Commission would review

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<sup>28</sup> SDG&E October 23, 2002 Comments page 12.

only the utilities conduct under the Operating Order or the utilities conduct under the underlying DWR Contracts. DWR also requests that the Commission clarify whether the utilities' operation and dispatch decisions will be subject to review by the Commission after Commission approval of the utility procurement plans. DWR requests that the Commission, consistent with the authority provided in Public Utilities Code Section 454.5(d)(2), establish sufficient regulatory processes that allow the Commission to verify and assure that the utilities are properly administering the DWR Contracts.

We agree with SCE that the ultimate arbiter of whether the utilities have complied with the terms and conditions of the Operating Order is the Commission, not DWR. PG&E's and SDG&E's requests ignore the explicit purpose of this Operating Order. It is precisely because DWR does not have authority to review or direct the utilities' actions that the Operating Order is required. Consistent with the discussion regarding the role of DWR, above, we note that DWR does not have authority to review the reasonableness of the utility's actions. As such, DWR will not be in a position to direct the utilities to administer a contract in a specific way other than to request compliance with the Operating Order, if necessary. The purpose of the Operating Order is to provide assurance to DWR and other relevant parties that DWR maintains the ability to monitor performance, obtain timely information, and adjust its revenue requirement. We will not adopt SDG&E and PG&E's proposed standards.

Without exception, the utilities propose review standards that would limit the scope of disallowance risk associated with the utilities' administration of the allocated DWR Contracts to a portion of the incremental costs of administering the DWR Contracts that the utilities seek to recover in rates. The utilities provide two primary arguments in support of this principle. First, they repeat the

argument that the Commission is legally constrained from disallowing costs incurred under the DWR Contracts. They claim that the Commission cannot indirectly disallow costs incurred under the DWR Contracts by reclassifying such action as a disallowance related to utility administration of those same DWR Contracts. The scope of risk, therefore, must be limited to a portion of the incremental costs of administering the DWR Contracts that are authorized for recovery by the Commission.

Second, the utilities claim that reasonable limits on liability are essential to support utility creditworthiness. They argue that if the risk of disallowance associated with the contract administration function is unlimited, the rating agencies may withhold investment grade ratings unless and until a track record is developed that establishes an acceptable scope of disallowance risk. They assert that, under the AB 57 framework, the Commission is required to evaluate the impact of its procurement decisions on the restoration of the utilities' investment grade credit rating. In order to address the financial community's concerns about the limitless nature of the disallowance risk, the utilities recommend that the Commission "cap" the potential disallowance at no more than a maximum 100% of the utilities' costs of administering the allocated DWR contracts that they seek to recover in their own rates. The utilities believe that this proposal would provide an incentive to do the job well without transferring the blame for bad contracts from DWR to the utilities.

Aglet argues that there is no sound reason to rule out utility liability for consequential damages and that the utilities must be held fully responsible for management decisions that involve high levels of ratepayer costs. Aglet suggests that the scope of any disallowance be tailored to the imprudent action.

We recognize the utilities' concerns regarding disallowance risk. As PG&E notes in its comments, under SB 1976, the Commission must evaluate the impact of its procurement decision on the restoration of the utilities investment grade credit rating. The Commission agrees, and we have considered the utilities arguments and determined that the credit risk has been overstated by the utilities. The potential risk associated with contract administration is considerable, but it is not unlimited.

The utilities' disallowance risk associated with the DWR Contracts is already limited by AB X1, which prohibits review of the terms and conditions of the DWR contracts. Limiting reasonableness review to the utilities' administration of the contracts provides significant risk protection for the utilities. We also note that the record leading up to D.02-10-062 demonstrates that there were only a limited number of disallowance decisions made by the Commission during the seventeen year period from 1980 to 1996 for the three utilities and that the majority of these decisions and dollar adjustments involved affiliate transactions<sup>29</sup>. The record simply does not support the utilities' assertions that the reasonableness review risk will impair the restoration of investment grade credit ratings. The utilities are focusing on the wrong set of risks. The greater risk is that the DWR Contracts will continue to be more expensive than market power for the foreseeable future. Under AB X1, this is not a risk that the utilities will bear, this risk is borne by the ratepayers. For them, there is no such risk protection. DWR's revenue requirement request for calendar year 2003 alone exceeds 5 billion dollars.<sup>30</sup> We must balance the utilities'

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<sup>29</sup> D.02-10-062, Page 49.

<sup>30</sup> DWR request 8-16-02.

concerns with ratepayer interests. If the utilities were to administer the contracts in such a way to as to enhance revenues from URG (and thereby decrease revenues associated with the DWR Contracts), the ratepayers will be harmed as DWR charges may have to increase to ensure recovery of DWR's revenue requirement.

The cap on disallowances proposed by the utilities does not adequately reflect the level of ratepayer risk. In addition, we want to avoid creating a framework under which the utilities, if tempted to perform some unreasonable action, could easily compare the penalty with the potential gains. We will not adopt the utilities proposal for a cap on potential disallowances.

SCE proposes that the Commission adopt a lower standard than the "reasonable manager" standard used by the Commission in past Energy Cost Adjustment Clause proceedings. Under SCE's proposed standard the utilities' administration of the contracts would be deemed reasonable absent evidence of gross negligence, of involved intentional misconduct, fraud, or a knowing violation of the law. SCE also proposes to define "least-cost" dispatch as a dispatch decision that either results in the lowest cost to the ratepayers on a forecast basis, or is required for reliability reasons (e.g., dispatching units out of economic order due to transmission constraints or overgeneration). SCE requests recognition that least-cost dispatch is not a precise exercise, and that dispatch practices should be deemed reasonable under the standard described above.

We concur with SCE that the definition of "least-cost" dispatch should encompass a reasonable range of decisions and our decision reflects that policy, however, we reject SCE's proposed reasonableness standard.

Aglet strongly opposes any lowering of the "reasonable manager" standard and suggests that, Commission standards should reflect that the overall

level of generation and procurement costs is higher than ever. Aglet recommends that the Commission adopt general principles for utility management performance, not strict rules for specific procurement situations. Aglet argues that the utilities have not justified abandoning the historical standards for reasonableness review. Aglet notes that although the circumstances have changed, the standards are meant to accommodate the changing conditions and specific facts surrounding each utility procurement decision. Aglet recommends that the Commission adopt a set of general standards for reasonableness review based on standards previously adopted by the Commission.

We see no reason to lower the reasonable manager standard for purposes of administering DWR Contracts.

We will retain the existing “reasonable manager” standard adopted in D.02-10-062, but we will also consider as factual predicates during the compliance review process the following: 1) the complexity of the DWR Contracts and the fact that they are not utility service territory specific, 2) the ongoing disputes between DWR and certain contract counterparties, and 3) the utilities’ combinations of up-front standards and specific framework for review initial lack of familiarity with the DWR Contracts. We believe that this results in a reasoned middle ground that recognizes the unique characteristics of the utilities assuming operation responsibility for the DWR Contracts while recognizing AB 57’s requirement that the utilities administer the DWR Contracts in a competent manner that benefits ratepayers. We adopt the standards previously adopted in D.02-10-062 with the explicit inclusion of a “least-cost” dispatch requirement. Prohibited utility conduct under this standard includes

any action that results in preference to URG resources or the utility's own negotiated contracts.

The adopted up-front standards are as follows:

1. The utilities shall prudently administer all contracts and generation resources and dispatch the energy in a least-cost manner.
2. The utilities shall not engage in fraud, abuse, negligence, or gross incompetence in procurement transactions or administering contracts and generation resources.

In comments on the Draft Decision, PG&E and SCE request language clarifying that the standard of proof in any reasonableness proceeding is based on “clear and convincing evidence that the utility’s actions were outside a range of reasonable managerial conduct” and had a net detrimental effect on customers. Adoption of this clarification would shift the burden of proof away from the utilities and onto parties seeking a disallowance. We believe that the utilities should bear the burden of proving that their conduct is reasonable. We reject PG&E and SCE’s request.

The utilities shall prudently administer all contracts and generation resources and dispatch the energy in a least-cost manner. Our definition of prudent contract administration and least-cost dispatch is the same as that adopted in the Draft Decision on Utility Procurement before the Commission as Item # 13 on the Commission’s December 17, 2002 Agenda with the additional clarification that prohibited utility conduct under the least-cost dispatch standard includes any action that results in inappropriate preference for URG resources or the utility’s own negotiated contracts.<sup>31</sup>

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<sup>31</sup> The definition of “least-cost” dispatch provided in the Draft Decision on Procurement states that: “Prudent contract administration includes administration of all contracts within the terms and conditions of those contracts, to include dispatching dispatchable contracts when it is most economical to do so. In administering contracts, the utilities

*Footnote continued on next page*

As stated above, the forum in which we will apply the reasonableness review standards will be the annual procurement proceedings, where the utility procurement process is reviewed as a whole.

### **Future Revisions**

In its reply comments dated November 8, 2002, SDG&E states that it “fully anticipates that over time, the informational requirements presently contemplated by Exhibit F will change or become unnecessary. In this event, it is sensible to allow the parties periodically to revisit what requirements should change or be deleted. To this end SDG&E suggests the following language be inserted at the end of the last paragraph at page A-6: “This Appendix will be revisited annually to ensure that data reporting remains relevant and useful.”

This provision seems reasonable given the breadth and the amount of information that is to be exchanged between the Utilities and DWR, however, we believe that this relook should apply to the Operating Order and the other exhibits as well. At a minimum, we expect the reporting process to be streamlined as the utilities and DWR become familiar with the exchange of

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have the responsibility to dispose of economic long power and to purchase economic short power in a manner that minimizes ratepayer costs. Least-cost dispatch refers to a situation in which the most cost-effective mix of total resources is used, thereby minimizing the cost of delivering electric services. PG&E's description of least-cost economic dispatch methodology described in its 1992 "Resource: An encyclopedia of energy utility terms", 2d edition, at pages 152-3 is appropriate with the recognition that a pure economic dispatch of resources may need to be constrained to satisfy operational, physical, legal, regulatory, environmental, and safety considerations. The utility bears the burden of proof to establish that it operated its system under least-cost economic dispatch except when it faced operational physical, legal, regulatory, environmental, or safety constraints, and that the manner in which it operated under constraints was reasonable.”

information. This review should occur as part of the annual review of the utilities' procurement plans. In addition, in order to be in a position to quickly identify and address potential issues, we should require the utilities and DWR to provide a report to the Commission after they have had several months' experience operating under this order. We will schedule a full panel hearing before the Commission on or soon after March 31, 2003.

In its comments on the Draft Decision, SCE requests that the Commission permit the utility to seek to terminate the Operating Order upon DWR and the utility entering into agreements which substantially and fundamentally in Section II, above comport with the terms and conditions in the Operating Order. As discussed with respect to DWR's December 9, 2002 memorandum, this request is reasonable. Upon entering into any such agreement, the utility should request approval of an Operating Agreement and termination of the Operating Order.

## **XII. Comments on Draft Decision**

The draft decision of the administrative law judge in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed on December 9, 2002, by PG&E, SDG&E and DWR. On December 17, 2002 SCE filed a motion for leave to file comments one day late. Reply comments were filed by SDG&E, PG&E and DWR on December 16, 2002.

As described in this decision we clarify our discussion of the standards for reasonableness review of utility contract administration, modify our findings regarding the reporting requirements, and make other clarifications and corrections in response to the comments.

### **XIII. Assignment of Proceeding**

Loretta M. Lynch is the Assigned Commissioner and Julie M. Halligan is the assigned Administrative Law Judge in this proceeding.

#### **Findings of Fact**

1. On September 6, 2002 DWR submitted a Memorandum in response to the Draft Decision in R.01-10-024 (the Draft Contract Allocation Decision) requesting that the Commission direct the utilities to propose and negotiate operating agreements, for approval by the Commission.
2. DWR and the utilities have been unable to agree on a mutually acceptable operating agreement.
3. The Commission has exclusive authority to review the utilities' contract administration of the DWR contracts.
4. We find that the "limited agency" definition appropriately reflects the nature of the capacity in which the utilities will be operating under this order. It is reasonable to require the utilities to act as a "limited agent" of DWR for the purposes of complying with the Operating Order.
5. There is no reason for DWR to provide a "certificate" to the utilities stating that they are in compliance with the Operating Order.
6. It is not necessary for DWR to approve the utilities' protocols and procedures for the use of DWR Contracts for Ancillary Services.
7. The provision of collateral is not a "right" under the contracts and therefore, can be performed by the utilities.
8. The operation and dispatch of the Contracts under three separate portfolios will be significantly different from operation of those same contracts on a state wide basis, therefore it is not reasonable to adopt a one-year "transition period".

9. Following DWR review of a Gas Supply Plan, the utilities should not need to obtain DWR approval for agreements entered into consistent with the plan.

10. Since the utilities will be responsible for managing the gas tolling provisions of the contracts as of January 1, 2003, including the responsibility for managing gas price risk, they should take action to determine the level of exposure and work with DWR to enter into any necessary forward hedges immediately.

11. Although the proposed procedure for payment of fuel-related obligations differs from the procedure adopted in D.02-09-053, the mutually agreed-upon procedure specified in Sections X and XIV of Exhibit B is reasonable and we adopt it with certain modifications.

12. In consideration of the circumstances leading to periods of surplus energy, we define surplus energy as a condition where dispatched supply from the utility's integrated portfolio occurs in excess of loads. Loads include retail load and existing utility non-retail loads and obligations.

13. SDG&E's approach for calculating surplus sales best serves to equitably integrate and adjust the surplus sales quantities between the utilities portfolios and the DWR Contracts.

14. Where a resource provides Ancillary Services or ISO Instructed Energy, the energy and or revenues should be tied to the resource and excluded from pro rata sharing.

15. The source of generation for exchanges should be counted as utility retained generation in the pro rata calculation.

16. Forward sales should be included in the pro rata calculation.

17. Negative surplus sales should be distributed pro rata.

18. The utilities' operational responsibilities should include the settlement functions.

19. Responsibility for ISO charges goes hand in hand with the responsibility for scheduling the power.

20. Responsibility for all ISO charges associated with serving the utilities' customers belongs with the utilities, consistent with their obligation to serve those customers.

21. The reporting requirements should be narrowly tailored to implement the requirements of this order. In particular, we should avoid duplicating any reporting requirements that already exist as a result of the Rate Agreement, the Servicing Arrangements, or the Bond Indenture.

22. It is not reasonable to establish a one-year "Transition Period" during which utility administration, operation, scheduling and dispatch of DWR contracts will not be subject to reasonableness review or disallowances of any kind.

23. We agree with SCE that the ultimate arbiter of whether the utilities have complied with the terms and conditions of the Operating Order is the Commission, not DWR.

24. There is no evidence to support the claim that the Operating Order will impair the restoration of the utilities' credit ratings.

25. To the extent that any of the requirements of this decision conflict with the Rate Agreement or the Servicing Orders, those orders govern.

### **Conclusions of Law**

1. The Commission's action ordering the utilities to comply with the Operating Order is consistent with the statutory authority in Water Code Section 80106.

2. The Operating Order is not an agreement between the utilities and DWR, but rather it is a Commission order directing the utilities to comply with the terms and conditions set forth in the Operating Order and the related attachments.

3. Pursuant to Water Code 80106(b), DWR may request that the Commission to order the utility to provide certain services.

4. Water Code Section 80134 does not authorize DWR reasonableness review of utility activities.

5. We should review utility contract administration on a timely and regular basis in concert with our review of the procurement plans contemplated in D.02-10-062.

6. The Operating Order and all of the related attachments should be approved, and the utilities should be ordered to comply with the Operating Order and attachments.

## **O R D E R**

### **IT IS ORDERED** that:

1. The Operating Order is approved and adopted as part of this decision.

2. The effective date of the Operating Order shall be today.

3. The utilities shall take all necessary actions to prepare to perform under this order in a timely and efficient manner.

4. The utilities shall comply with the following up-front standards of conduct:

1. The utilities shall prudently administer all contracts and generation resources and dispatch the energy in a least-cost manner. Our definitions of prudent contract management and least cost dispatch are the same as our existing standard.

2. The utilities shall not engage in fraud, abuse, negligence, or gross incompetence in negotiating procurement transactions or administering contracts and generation resources.
5. Pursuant to Water Code Section 80106, each utility shall be ordered to comply with all terms and conditions of the Operating Order as set forth in Attachment A of this decision.

This order is effective today.

Dated December 19, 2002, at San Francisco, California.

LORETTA M. LYNCH  
President  
CARL W. WOOD  
GEOFFREY F. BROWN  
MICHAEL R. PEEVEY  
Commissioners

I abstain.

/s/ HENRY M. DUQUE  
Commissioner